REPORT OF EXAMINATION
OF

PACIFIC SPECIALTY INSURANCE COMPANY

AS OF
DECEMBER 31, 2004

Participating State
and Zone:

California

Filed May 25, 2006

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San Francisco, California
April 15, 2006

Honorable Alfred W. Gross
Chairman of the NAIC Financial
Condition (EX4) Subcommittee
Commissioner of Insurance
Virginia Bureau of Insurance
Richmond, Virginia

Honorable Gary L. Smith
Secretary, Zone IV-Western
Director of Insurance
Department of Insurance, State of Idaho
Boise, Idaho

Honorable John Garamendi
Insurance Commissioner
California Department of Insurance
Sacramento, California

Dear Chairman, Director and Commissioner:

Pursuant to your instructions, an examination was made of

PACIFIC SPECIALTY INSURANCE COMPANY

(hereinafter also referred to as the Company) at its home office located at 3601 Haven Avenue, Menlo Park, California 94025.

SCOPE OF EXAMINATION

The examination was conducted pursuant to the National Association of Insurance Commissioners' (NAIC) plan of examination. The previous examination of the Company was made as of December 31, 2000. This examination covers the period from January 1, 2001 through December 31, 2004.

The present examination of the Company included a review of the Company's practices and procedures, an examination of management records, tests and analyses of detailed transactions, an evaluation of assets, and a determination of liabilities as of December 31, 2004, as deemed necessary under the circumstances. In addition to those items specifically commented upon in this report, other phases of the Company's operations were reviewed including the following areas that require no further comment: fidelity bonds and other insurance; corporate records; growth of company; business in force by states; loss experience; and officers', employees' and agents' welfare and pension plans.

SUBSEQUENT EVENTS

On September 2, 2005, the Company purchased two and one-half acres of vacant land located in Atherton, California for $10.5 million. On September 6, 2005, the Company sold an undivided 30% interest in the land at cost to its parent, Western Service Contract Corporation. In the 2005 Annual Statement, the Company valued its investment in this land at $7.4 million. California Insurance Code Section 1194.8 (a) states in part as follows:

> "Excess fund investments may be made by a domestic insurer in real estate and leases thereof and in making improvements thereon for business or residential purposes as an investment for the production of income…."

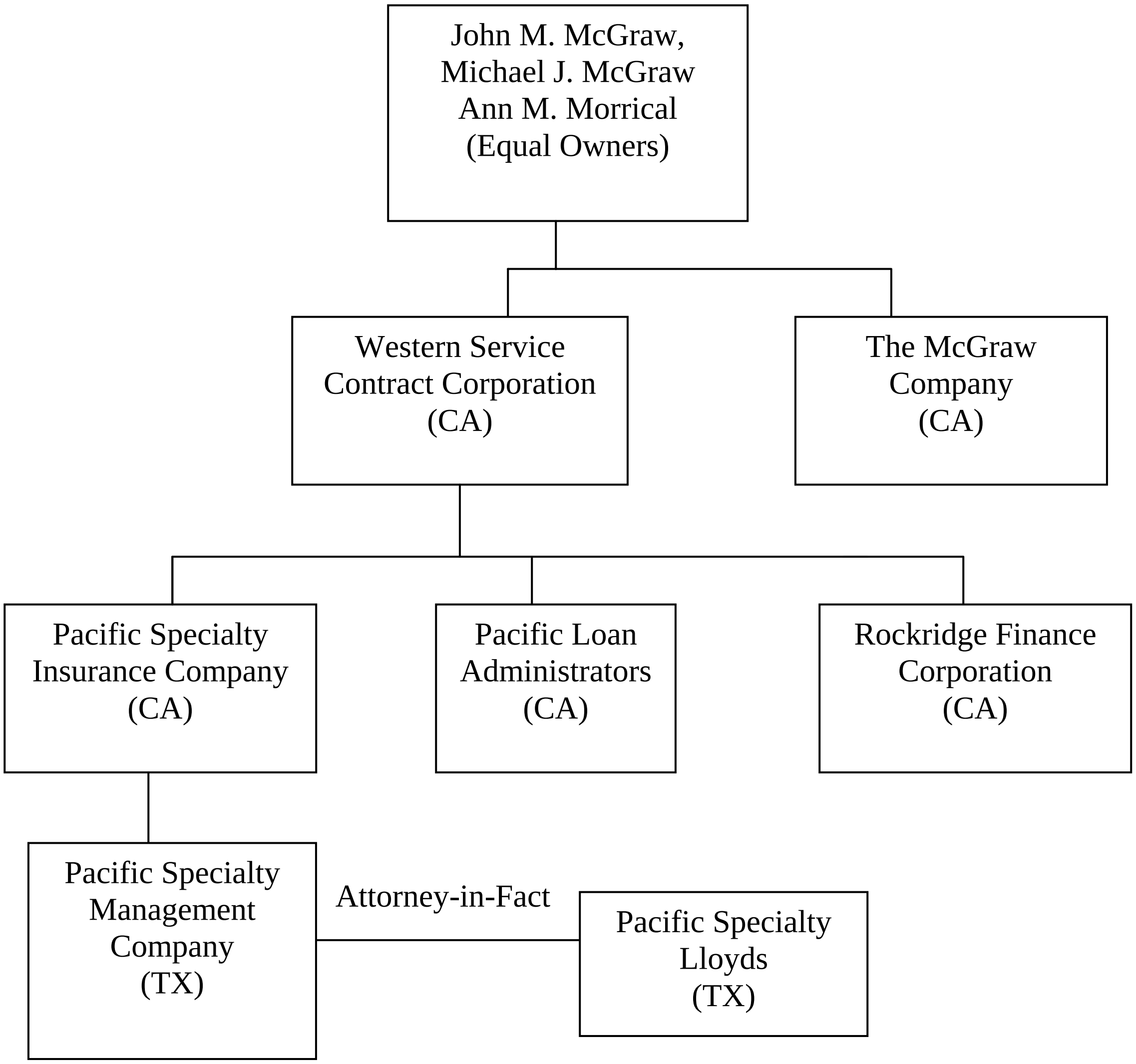
Since its acquisition, the land has not produced income. The Company has stated that it is in the process of preparing the land for sale and expects to sell it in the next two months at a profit.

COMPANY HISTORY

The Company's parent, Western Service Contract Corporation, contributed $5 million in cash to the Company in December 2003. No dividends were paid to the parent from January 1, 2001 through April 15, 2006.

MANAGEMENT AND CONTROL

The Company is a member of an insurance holding company system of which the ultimate controlling persons are John M. McGraw, Michael J. McGraw, and Ann M. Morrical. The following chart depicts the interrelationship of the Company within the holding company system as of December 31, 2004:



All ownership is 100% unless otherwise indicated.

Management of the Company is under the control of a seven-member board of directors. The directors and principal officers serving as of December 31, 2004 are as follows:

Directors

Name and Residence	Principal Business Affiliations
Eugene E. Becker Naples, Florida	Insurance Industry Consultant
John V. McGraw, Jr. Atherton, California	Chairman Pacific Specialty Insurance Company
Michael J. McGraw Atherton, California	President and Chief Executive Officer Pacific Specialty Insurance Company
Brian J. McSweeney Redwood City, California	Executive Vice President, General Counsel and Treasurer Pacific Specialty Insurance Company
William F. McCauley Coronado, California	Retired Admiral United States Navy
Ann M. Morrical San Francisco, California	Homemaker
Timothy J. Summers Redwood City, California	Executive Vice President and Secretary Pacific Specialty Insurance Company

Principal Officers

Name	Title
Michael J. McGraw	President and Chief Executive Officer
Timothy J. Summers	Executive Vice President and Secretary
Brian J. McSweeney	Executive Vice President, General Counsel and Treasurer
David L. Sacks	Vice President, Chief Financial Officer
Donald A. McAllister	Vice President, Information Systems
Susan Valencia	Vice President, Underwriting
Brian F. Weaver	Vice President, Sales
William H. Guthrie	Vice President, Product Development

Management Agreements

Agreement to Pay Allocation of Overhead Charges

Under an agreement between The McGraw Company (McGraw), other affiliated companies and the Company, McGraw provides office space, supplies, salaries, advertisement, and other overhead expenses and allocates them to the members of the group based on its actual costs. The method of allocation among the affiliates was reviewed and determined to be in compliance with California Insurance Code Section 1215.

Federal Income Tax Allocation Agreement

The Company is a party to a federal income tax allocation agreement with its affiliates Western Service Contract Corporation (WSCC), Pacific Loan Administrators, and Rockridge Finance Corporation. The tax liability is allocated based on each member's share of the taxable income. WSCC is the one filing the consolidated federal tax return. Inter-company settlement is required within 90 days. The Company's affiliate, McGraw, is not a party to this agreement.

General Agency Agreement

The Company is party to a general agency agreement with McGraw. McGraw receives and accepts proposals for insurance, performs underwriting functions, issues and cancels insurance policies, and collects premium. McGraw is required to remit premiums to the Company within 30 days and receives 25% commission. The agreement indicates that the maximum premium volume that can be underwritten and collected by McGraw on behalf of the Company is $50 million in California; however, the actual premium volume produced by McGraw in California in 2004 was $131 million. It is recommended that the Company amend the agreement to reflect the maximum premium volume that can be underwritten and collected by McGraw.

TERRITORY AND PLAN OF OPERATION

As of December 31, 2004, the Company was licensed to write property and liability insurance in all fifty states and the District of Columbia. The majority of the Company's direct premium written were in the following states: California (86%), Florida (5%), and Georgia (5%). The book of business was mostly personal lines that included (by percentage of direct 2004 premiums written) homeowners multiple peril (71%), private passenger auto (15%), inland marine – boat and personal watercraft (4%), other liability – personal umbrella (4%), and earthquake (3%). Commercial multiple peril represented only 2% of the total direct premiums written.

Approximately $145 million or 95% of the Company's direct premium written in 2004 was produced by its affiliated general agent, The McGraw Company. A managing general agent, Mobile Homeowners Insurance Agencies, Inc., located in Pinellas Park, Florida, produced $6.5 million of mobile home business for the Company in 2004; however, it ceased writing new and renewal business for the Company at the end of 2004 except those with open claims. The Company had 325 mobile home policies in force at December 31, 2005.

REINSURANCE

Assumed

The Company had two assumed reinsurance agreements in effect at December 31, 2004. One was with Old American County Mutual Fire Insurance Company (Old American), which is domiciled in Texas. In this agreement, the Company assumed 100% of the motorcycle business written by Old American in Texas. Assumed premiums for this agreement totaled $2.4 million in 2004. The other agreement was with Pacific Specialty Lloyds, an affiliate domiciled in Texas. In this agreement, the Company assumed 100% of the fire, allied lines and liability business written by Pacific Specialty Lloyds in Texas. Assumed premiums for this agreement totaled $96,000 in 2004.

Ceded

The Company's ceded reinsurance program was arranged through Willis Re Inc., a reinsurance intermediary. The Company's reinsurance program at year-end 2004 is outlined below:

Reinsurance Contract	Participating Reinsurer	Company Retention	Reinsurer Limit
Multiple Line Excess of Loss – First Layer	Platinum Underwriters Reinsurance Inc. 35% QBE Reinsurance Corporation 15% The TOA Reinsurance Company of America 50%	$600,000 per risk or per occurrence	$600,000 per risk or per occurrence
Multiple Line Excess of Loss – Second Layer	Platinum Underwriters Reinsurance Inc. 35% QBE Reinsurance Corporation 15% The TOA Reinsurance Company of America 50%	$1.2 million per risk or per occurrence	$1 million per risk or per occurrence
Multiple Line Excess of Loss – Third Layer	Odyssey American Reinsurance Corporation 50% Platinum Underwriters Reinsurance Inc. 35% QBE Reinsurance Corporation 15%	$2.2 million per risk or per occurrence	$1 million per risk or per occurrence
Property Catastrophe – First Excess	Folksamerica Reinsurance Company 20% IPCRe Limited * (Bermuda) 22.5% Sirius International Insurance Corporation * 7.5% Underwriters at Lloyds 50%	$5 million each loss occurrence	$5 million each loss occurrence
Property Catastrophe – Second Excess	Folksamerica Reinsurance Company 20% IPCRe Limited * (Bermuda) 15% Underwriters at Lloyds 65%	$10 million each loss occurrence	$10 million each loss occurrence

Reinsurance Contract	Participating Reinsurer	Company Retention	Reinsurer Limit
Property Catastrophe – Third Excess	Folksamerica Reinsurance Company 23% Endurance Specialty Insurance Ltd. * (Bermuda) 6.563% IPCRe Limited * (Bermuda) 14.5% Sirius International Insurance Corporation * 4% Underwriters at Lloyds 51.937%	$20 million each loss occurrence	$15 million each loss occurrence
Property Catastrophe – Fourth Excess	Folksamerica Reinsurance Company 10% Endurance Specialty Insurance Ltd. * (Bermuda) 20% IPCRe Limited * (Bermuda) 5% Odyssey America Reinsurance Corporation 7.5% Underwriters at Lloyds 57.5%	$35 million each loss occurrence	$15 million each loss occurrence
Personal Umbrella – Quota Share	New Jersey Reinsurance Company * 20% Odyssey America Reinsurance Corporation 45.19% The TOA Reinsurance Company of America 34.81%	25%	75%; maximum policy limit issued by the Company is $5 million
Residential Earthquake – Quota Share	ACE Tempest Reinsurance Ltd. * (Bermuda) 26% Converium Reinsurance (North America) Inc. 26% Endurance Specialty Insurance Ltd. * (Bermuda) 9% Odyssey America Reinsurance Corporation 15.5% XL Re Ltd. * (Bermuda) 23.5%	5%	95%; subject to a limit of 95% of $22 million for each loss occurrence

Reinsurance Contract	Participating Reinsurer	Company Retention	Reinsurer Limit
Florida Mobile Home – Quota Share	AXA Re*	5%	95%; subject to a limit of the following: $15,988,500 each occurrence (7/1/04-9/30/04) $14,335,500 each occurrence (10/1/04-12/31/04) $11,989,000 each occurrence (1/1/05-3/31/05) $9,357,000 each occurrence (4/1/05-7/1/05)

* Non-admitted carriers.

ACCOUNTS AND RECORDS

Transactions with affiliates including amounts for the cost allocation agreement, the tax allocation agreement and commissions were not reported on Schedule Y, Part 2 of the 2004 Annual Statement. It is recommended the Company take corrective action on this matter.

During the course of the examination, a review was made of the Company's general controls over its information systems. As the result of this review, recommendations for improving the Company's information systems controls were developed and presented to the Company. The Company should evaluate these recommendations and make appropriate changes to strengthen its controls over its information systems.

FINANCIAL STATEMENTS

The financial statements prepared for this examination report include:

Statement of Financial Condition as of December 31, 2004

Underwriting and Investment Exhibit for the Year Ended December 31, 2004

Reconciliation of Surplus as Regards Policyholders from December 31, 2000 through December 31, 2004

Statement of Financial Condition
as of December 31, 2004

Assets	Ledger and Nonledger Assets	Assets Not Admitted	Net Admitted Assets	Notes
Bonds	$152,662,749	$	$152,662,749	
Stocks: Preferred	413,000		413,000	
Common	23,802,904		23,802,904	
Mortgage loans on real estate	9,160,000		9,160,000	
Cash and short-term investments	21,125,783		21,125,783	
Other invested assets	6,983,346		6,983,346	
Investment income due and accrued	1,839,208		1,839,208	
Uncollected premiums and agents' balances in the course of collection	2,402,544		2,402,544	
Deferred premiums, agents' balances and installments booked but deferred and not yet due	7,162,174		7,162,174	
Amounts recoverable from reinsurers	(121,263)		(121,263)	(1)
Net deferred tax asset	7,257,893	1,773,622	5,484,271	
Receivable form parent, subsidiaries and affiliates	111,595		111,595	
Total assets	$232,799,933	$ 1,773,622	$231,026,311	

Liabilities, Surplus and Other Funds

Losses		$ 39,309,479	(2)
Reinsurance payable on paid loss and loss adjustment expenses		19,368	
Loss adjustment expenses		16,604,826	(2)
Commissions payable, contingent commissions and other similar charges		269,036	
Other expenses		1,611,690	
Taxes, licenses and fees		1,000,000	
Current federal income tax		3,183,899	
Unearned premiums		65,973,776	
Advance premiums		2,289,693	
Ceded reinsurance premiums payable		(235,974)	
Provision for reinsurance		5,627,000	
Drafts outstanding		11,753,770	
Payable to parent, subsidiaries and affiliates		131,739	
Payable for securities		3,476,498	
Aggregate write-ins for liabilities		5,176,098	
Total liabilities		156,190,898	
Common capital stock	$ 3,500,000		
Gross paid-in and contributed surplus	6,000,000		
Unassigned funds (surplus)	65,335,413		
Surplus as regards policyholders		74,835,413	
Total liabilities, surplus and other funds		$231,026,311	

Underwriting and Investment Exhibit
for the Year Ended December 31, 2004

Statement of Income

Underwriting Income		
Premiums earned		$111,937,972
Deductions:		
Losses incurred	$47,274,320	
Loss expenses incurred	9,374,048	
Other underwriting expenses incurred	50,372,258	
Total underwriting deductions		107,020,626
Net underwriting gain		4,917,346
Investment Income		
Net investment income earned	$ 6,027,327	
Net realized capital gains	2,982,059	
Net investment gain		9,009,386
Other Income		
Finance and service charges not included in premiums	$ 451,554	
Total other income		451,554
Net income before federal income tax		14,378,286
Federal income tax incurred		5,065,731
Net income		$ 9,312,555

Capital and Surplus Account

Surplus as regards policyholders, December 31, 2003		$ 72,827,185
Net income	$ 9,312,555	
Change in net unrealized capital gains	336,139	
Change in net deferred income tax	2,626,234	
Change in nonadmitted assets	(787,442)	
Change in provision for reinsurance	(5,627,000)	
Aggregate write-ins for losses in surplus	(3,852,258)	
Change in surplus as regards policyholders for the year		2,008,228
Surplus as regards policyholders, December 31, 2004		$ 74,835,413

Reconciliation of Surplus as Regards Policyholders
from December 31, 2000 through December 31, 2004

	Gain in Surplus	Loss in Surplus	
Surplus as regards policyholders, December 31, 2000, per Examination			$ 48,412,010
Net income	$ 20,854,070	$	
Net unrealized capital gains	1,075,220		
Change in net deferred income tax	5,221,987		
Change in nonadmitted assets		1,773,622	
Change in provision for reinsurance		5,627,000	
Cumulative effect of changes in accounting principles	2,035,903		
Capital paid in	5,000,000		
Aggregate write-ins for gains and losses in surplus		363,155	
Total gains and losses in surplus	$ 34,187,180	$ 7,763,777	
Increase in surplus as regards policyholders			26,423,403
Surplus as regards policyholders, December 31, 2004, per Examination			$ 74,835,413

COMMENTS ON FINANCIAL STATEMENT ITEMS

(1) Amounts Recoverable from Reinsurers

The Company did not maintain an aging report on reinsurance recoverable and did not report any overdue reinsurance recoverable on Schedule F, Part 4 of the 2004 Annual Statement. It is recommended that the Company maintain an aging report to keep track of its reinsurance recoverable. A review of the Company's reinsurance billing and collection work papers indicated that the amount of overdue reinsurance recoverable appeared immaterial as of December 31, 2004.

(2) Losses and Loss Adjustment Expenses

The loss and loss adjustment expense reserves were reviewed by a California Department of Insurance Casualty Actuary. It was determined that the loss and loss and adjustment expense reserves established by the Company at December 31, 2004 were reasonable.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

Current Report of Examination

Management and Control – Management Agreements–General Agency Agreement (Page 5): During 2004, The McGraw Company (McGraw) produced direct premiums in excess of those permitted under the language of the contract. It is recommended that the Company amend the agreement with McGraw to reflect the maximum premium volume that can be written in California.

Accounts and Records – (Page 9): It is recommended that the Company report all transactions with affiliates on Schedule Y, Part 2 of the annual statement. In addition, the Company should evaluate the examiner's recommendations on its information systems and make appropriate changes.

Comments on Financial Statement Items- Amounts Recoverable from Reinsurers – (Page 14): It is recommended that the Company maintain an aging report to keep track of its reinsurance recoverable.

Previous Report of Examination

Reinsurance – (Page 5): It was recommended to have a currency clause, particularly when the reinsurers are of foreign origin. Each of the Company's reinsurance contracts now includes a currency clause.

Accounts and Records – (Page 9): It was recommended that the Company comply with the State of California escheat laws. No violations of the State of California escheat laws were noted in this examination.

Accounts and Records – (Page 8): It was recommended that the Company report amounts for the cost allocation agreement, the tax allocation agreement, and commissions to both McGraw agents. As recommended in the current examination report, Company needs to report all of the above in the annual statement.

ACKNOWLEDGEMENT

The courtesy and cooperation extended by the Company's officers and employees during the course of this examination are hereby acknowledged.

Respectfully Submitted,

Kelvin Ko, CFE
Examiner-In-Charge
Department of Insurance
State of California